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NEA/ARP SAWYER, EEB/ESC/IEC/EPC FOR MCMANUS

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TAGS: EPET ENRG EINV KU IZ
SUBJECT: WHILE KUWAIT PUSHES AHEAD ON OIL AND GAS, CHEVRON
PULLS OUT

REF: KUWAIT 1023

Classified By: Ambassador Deborah Jones for reasons 1.4(b) and (d).

¶1. (C) Summary: The Kuwait Oil Company CEO described plans for expansion of oil production capacity to 4 million barrels per day (mmb/d) by 2020 from its current 2.8 mmb/d. He confirmed the key to reaching this goal is creating a new type of agreement which is financially attractive to international oil companies(IOCs), and which avoids inflaming opposition in the National Assembly. One major technical services agreement for some of Kuwait's oil fields reportedly is near completion. However, Chevron suddenly halted its effort to extend its services agreement for Kuwait's largest oil field, potentially opening the way for other IOCs to obtain this prized contract. Kuwait's gas production goal remains 2 billion cubic feet per day in 2015. It also is near finalization of a gas importing deal with Qatar for summer month supplies via chartered tankers. The audit report on the proposed Fourth Oil Refinery is expected to be released by early December. End summary.

Oil Production

¶2. (C) KOC CEO Sami Fahad Al-Reshaid laid out for Econoff, Kuwait's path to increasing expanding oil production capacity to 4 million barrels per day by 2020. He explained that Kuwait's capacity was currently about 2.8 million barrels per day (mmb/d). It would grow to 3 million bpd by mid 2009 through expanding capacity in Burgan Field (Kuwait's largest, which currently can produce up to 1.8 million bpd) and in the western oil fields. Al-Reshaid said most of the remaining 1 million bpd of expansion would come from development of Ratga Field in northern Kuwait which eventually would produce 700,000 bpd of heavy oil. (Note: This projection for Ratga Field is consistent with the upper end of Exxon's production expectations for the field. Exxon is discussing development of the field with KPC(reftel). End note). The remaining 300,000 bpd of capacity would be produced from Kuwait's new non-associated Sabriyah gas field, once it reaches its targeted production rate of 1 billion cubic feet of natural gas per day (according to numerous published accounts of development plans for the gas field). At 1 billion cfd, KOC projects the field would produce up to 350,000 bpd of light crude and condensates.

¶3. (C) Reshaid and ExxonMobil Kuwait CEO John Hoholick said the Ratqa negotiations involved a novel type of agreement with an IOC. The downstream portion of the agreement would involve a joint venture between ExxonMobil and KNPC similar to that between Dow Chemical and Petrochemical Industries Company of Kuwait, while the upstream part of the agreement would involve a standard TSA. Both Reshaid and Hoholick acknowlQged that the purpose of this deal structure was to find a vehicle that would avoid virulent opposition in parliament and still be worthwhile financially for ExxonMobil. Hoholick described the downstream joint venture part of the agreement as the key, referring to the upstream activity as more or less a "loss leader."

Operating Agreements

¶4. (C) KOC's Reshaid said that the company was negotiating technical services agreements for oil and gas production in four different fields with four international oil companies(IOCs): Chevron for Burgan Field; British Petroleum for the western area; Shell for the non-associated gas field; and Exxon-Mobil for Ratqa field in the north. He anticipated concluding two of the contracts by the end of this year. (Note: Many observers believed that BP and Chevron were the two leading contenders to conclude their deals this year since both have had long existing production relationships with Kuwait. End Note.)

Meanwhile Chevron Reverses Course

¶5. (C) However, on November 17, Chevron Kuwait CEO Hani Iskander(protect) told Emboff that, despite having reached agreement with KOC on the "difficult issues," Chevron would not be signing an agreement with KOC for continued operation services in the Burgan Field. Iskander said that review by the Legal Department at Chevron's headquarters had belatedly raised concerns about provisions in the Kuwait agreement that could potentially trigger huge tax liabilities for Chevron's extensive services contracts around the world. The provisions in question were precisely those that made the overall operating agreement financially attractive to an IOC. Specifically, they would authorize payment to Chevron of $3 million(protect) for each Chevron employee providing technical services on the project, an amount far above standard market rate compensation, while specifying a set number of Chevron employees who would provide these services. This tactic is necessary because the Kuwait constitution, absent an authorizing law from parliament, does not permit foreign companies to set up production sharing agreements and "book reserves." Chevron's home office concerns were that recent Internal Revenue Service rulings might result in Chevron Corporation having to apply the concept of "deemed or transferred value" to its service contract revenues obtained in other countries at market rates of compensation. In other words, if Chevron were compensated at a given rate in Venezuela for using a technical services employee and the rate or compensation under the Kuwait contract was 10 times that rate, the IRS might "deem the value" per technical services employee of the Venezuelan contract as equal to that in the Kuwait contract, and tax Chevron at a rate ten times higher than its revenue received for the services. Per Iskander, this potentially huge tax liability led Chevron headquarters to recommend against approving the deal with KOC.

¶6. (C) Iskander said that Chevron had stopped providing services to Burgan Field in August and would be pulling most of its personnel out of Kuwait in January. It would remove the remainder in May 2009. He said the "transferred value" risk would be faced by all U.S. oil companies undertaking an Enhanced Technical Services Agreement along the lines of the Chevron agreement. Furthermore, Chevron headquarters' perception that KOC was excessively difficult -- exacerbated by the problems posed by its constitutional provisions on foreign ownership of oil reserves -- is leading to serious consideration of downgrading Kuwait to a second tier prospect in Chevron's future deliberations on allocating its resources.

Production Prospects for Burgan Field

¶7. (C) Iskander said under the terms negotiated with KOC, Chevron would have committed to producing 1.7 mmb/d from Burgan Field until 2020. He said they would have increased production from two smaller more challenging reservoirs while reducing production from the main Burgan reservoir, maintaining the latter's capacity as a swing production

source. Iskander assesses that, in the absence of sophisticated field management by a major IOC, production at Burgan could only be maintained at 1.7 mmb/d for a handful of years and that production could fall below 1 mmb/d within ten years.

Gas Production

¶8. (C) Mohammed Al-Otaibi, KOC Gas Management Group Director, said that KOC currently produces 1.2 billion cubic feet per day of natural gas with 16-18% of the gas extracted as methane and ethane for delivery to Kuwait's petrochemical industry and the remainder delivered to the Ministry of Electricity and Water for generation of electricity. The gas represents about 20% of the fuel used to generate electricity in Kuwait, with fuel oil providing the rest of the feed stock. Otaibi confirmed the current KOC plan to add an additional 1 billion cfd of expected production(in 2015) from the new non-associated gas discovery in Kuwait's northern Sabriyah field. He added that a source in KOC told him to expect gas production in about 2016 from the offshore Durra Field, which is the subject of ongoing dispute between Kuwait and Iran. The source did not elaborate on the basis of this expectation.

Power generation

¶9. (C) Otaibi described the current and long-term imbalance between Kuwait's domestic natural gas resources and its projected demand: even if development of the new non-associated gas field reaches its production goal of 1 billion cfd by 2015, doubling Kuwait's current natural gas production, Kuwait would still be well short of the amount of gas needed to generate all or even half its needed electricity in 2015, when demand is projected to be 50% above 2008 levels. With electricity demand in 2020 expected to be double that of 2008, Kuwait would still be generating only 20% of its electricity from natural gas.

¶10. (C) To address this need for additional natural gas, Kuwait Petroleum Corporation Deputy Managing Director and General Counsel Shaykh Nawaf Saud Nasir Al Sabah told Econcouns that KPC was finalizing a deal with Qatar for natural gas deliveries during the summer months when electricity demand in Kuwait is highest. Nawaf said the goals of the deal were to lessen the financial impact of consuming the more valuable domestic crude oil instead of exporting it, and also to lessen the environmental impact of using the dirtier high-sulphur Kuwaiti oil. Regarding potential gas import deals with Iran or Iraq, Nawaf said that Kuwait had regular discussions with Iranian energy officials about a possible gas deal, but dismissed any deal as unlikely, observing "it is impossible to negotiate with the Iranians. Whenever you agree on something in one meeting; inevitably it is disregarded or disowned in subsequent negotiations." He similarly downplayed the likelihood of a gas deal with Iraq but did not detail the reasons. (Note: Shaykh Nawaf is the son of former Oil Minister and Ambassador to the U.S. Shaykh Saud Nasir Al Sabah and is the nephew and son-in-law of the GoK Foreign Minister Shaykh Dr. Mohammed Al Sabah. End note.)

Oil Price Effect on Production

¶11. (C) Regarding the recent steep drop in crude oil prices and Kuwait's announcement that it would reduce oil deliveries by 5% during the month of November, in line with OPEC's decision to reduce production allocations for its members, KOC's Reshaid said that Kuwait had not decided on an extended reduction of exports and would continue its normal practice of evaluating its export volume on a month

by month basis.

Fourth Refinery/Project Kuwait

¶12. (C) Reshaid said that he expected the report of the Audit Bureau on the awarding of contracts for Kuwait's fourth refinery in Al-Zour to be issued during early December. He said that he did not expect the report to contain any substantial criticism of KNPC's contracting process, though he did anticipate the report would identify some minor procedures that should be modified. (Note: Some have argued forcefully that Kuwait should proceed with their project for purposes of asserting territorial sovereignty if for not other reason. End note.)

Comment

¶13. (C) Kuwait's goal of increasing its oil production capacity will depend not only on developing new fields, but on maintaining and expanding production at some of its older fields, particularly the Burgan field. Chevron's unexpected withdrawal from servicing the world's second largest oil field will open a huge opportunity for the major IOC's who likely will have the inside track on gaining the services agreement for the mature Burgan Field which analysts believe is entering an increasingly difficult phase of its productive life. The Chevron move could also complicate KOC's near-term plans to expand capacity in Burgan.

¶14. (C) In the longer term, development of the Ratga field and the non-associated Sabriyah gas field will require significant participation by International Oil Companies. Given the tortured history of parliamentary opposition to Project Kuwait -- the long-delayed scheme to develop Kuwait's northern oil fields -- skepticism about the successful establishment of the two projects is reasonable. However, the only path to expanding oil production on the scale Kuwait envisions is through development of the technically challenging Northern Fields. A successful development plan will require three elements: avoidance of anything that can be easily depicted as 'foreign ownership' of Kuwait's oil or natural gas; an acceptable risk/return ratio for the participating IOC; and GoK leaders willing to respond forcefully or with adequate political acumen to overcome inevitable high-profile opposition from some elements of the National Assembly. The plan under negotiation by ExxonMobil holds promise in meeting the first two requirements. Time will tell whether the GoK leadership will find the spine or savvy to close the deal. End comment).

JONES